

The argument was made earlier that we ought to think about ways of measuring some of the variables involved here, and I would argue that we have a potential test of how big incumbency advantage is, and that is all of the RBOCs are incumbents, and they are all competing against entering CLECs.

Ameritech has been very proud of the fact that it has actually lost a measurable number of its access lines to CLECs, announcing that there is in fact competition, and this in fact suggests that the incumbency advantage in region is not big enough and that CLECs are competing on a level ground.

How can I square the notion that to go out of region I need to have an incumbency advantage by serving one building of that potential customer in region when in fact I see that I cannot even hold that customer in region because CLECs can come in and compete?

MR. ROGERSON: Okay. Rich Gilbert would like to explain, as I understand it, why it is that CLECs did not need a whole bunch of existing customers to chase, yet have been doing quite well.

MR. GILBERT: Pat, this is not about incumbency advantage. This is about a network advantage. In fact, the concern that the ILECs have is that the interexchange carriers have these relationships, and they have the

relationships on a national level and are promoting the ability to provide this end to end competition.

They are quite concerned about being able to compete for all their customers. To do that, you have to have a similar presence, so I think it is not about incumbency at all.

MR. CARLTON: Can I just add one thing to that? The fact that one person believes that there is some advantage to incumbency while other firms, MCI, AT&T, may have other strategies does not mean that any one of these advantages is absolute. It means that one firm thinks it has an advantage over another firm on some dimensions. Maybe on other dimensions it does not.

Therefore, my view is you should let them exploit what they think is their desirable business strategy. Your question is will it be a success? My view is I would let the marketplace determine whether it will be a success. SBC has put in an enormous effort to this national/local plan.

MR. ROGERSON: I cannot resist but to ask the question that Bob Litan asked in his remarks to the panelists.

Suppose we approve these mergers, and then suppose next year we are here at a panel, and there are two more proposed mergers before us. Bell Atlantic wants to buy Bell South, and SBC wants to buy U.S. West, and they tell us that

Bell South and U.S. West are not providing much competition anyhow. They are too little.

There would be efficiencies if the mergers occurred, and in fact they could do a more dynamic national competition strategy if we allowed those mergers. Would those be good mergers? More to the point, would the arguments you are making today apply equally well to those mergers?

MR. CARLTON: I think the answer is simple.

MR. ROGERSON: Yes.

MR. CARLTON: I think the answer is you can ask abstract questions, but you would obviously have to evaluate it at the time the merger occurs, and you would have to look at the circumstances at that time.

MR. ROGERSON: Yes.

MR. CARLTON: I think it is quite clear that right now there is a very clear answer to the question you and Michael asked. Would a merger of all the RBOCs be good? The answer from these two mergers that are proposed is quite clear that these guys are going to each pursue some out of region policy. It is clear it is horizontal, in my view, and --

MR. ROGERSON: Right, but I am not --

MR. CARLTON: -- we would allow it.

MR. ROGERSON: -- asking would a merger between

SBC and Bell Atlantic be thinkable. I am willing to believe that the arguments that the proponents are making today indicate that that would be a bad idea because you are both claiming you are going to compete against each other.

What I am asking you is are the arguments you are making today consistent with making an argument next year that Bell Atlantic should be allowed to buy Bell South and that SBC should be allowed to buy U.S. West?

MR. CARLTON: I would say it is not inconsistent and may be consistent. It depends on the circumstances at the time.

MR. LITAN: Bill? Bill, can I just add? I just want to go to the moving your customer point.

MR. ROGERSON: Okay.

MR. LITAN: I just want to make one 30 second intervention. All right. I can understand how SBC wants to follow its Dallas customer that moves out of region. All right. Ditto with Ameritech having an incentive to follow a Chicago customer who goes out of region. They each have incentive to follow.

Now, the thing that I do not understand is that when you put them together, the combined entity now has more of an incentive than each one of them separately had to begin with. I do not understand that.

MR. ROGERSON: Okay. Roger?

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MR. NOLL: They do have an incentive because contrary to the assertions that have been made, competition in access is more prospective than it is real. It is more profitable to be a monopoly.

Most of the arguments we are hearing are it is more profitable and cheaper to form the ubiquitous interconnected network that will track all the customers if there is only one wire line base carrier than if there are two. That is the essence of the argument.

The point that we should bear in mind is that as analysts, we should not care who the first ubiquitous national network is, and it is intriguing and it is probably true that if all the ILECs merged together they could ubiquitously be one, and they are saying but we need to be allowed to do that because if you do not, AT&T will be there first with its cable companies.

Our view about that should be A, AT&T and the TCI thing is prospective, not real. It is about the nineteenth idea in the last ten years about how to create the ubiquitous firm. None of them have worked yet, and because there are downside risks to creating the single ubiquitous wire line carrier, we should not do it until we know that is in fact how the market is going to work.

MR. ROGERSON: Okay. I am going to cut the discussion off here and move us to our next session. Our

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next session is asking the question will these mergers have an effect on the FCC's ability to benchmark across firms?

I have asked Joe Farrell to speak for five minutes to explain what this possible harm is, and then I have asked Robert Crandall and Dennis Carlton both to critique Joe's presentation.

Joe, go ahead.

MR. FARRELL: Thanks, Bill.

Regulation inherently involves holding a regulated firm to some kind of performance standard or pricing standard that the regulated firm has not freely chosen. That raises some risks obviously. The goal is to make this performance standard or pricing standard or whatever it is efficiently challenging for the firm, but feasible.

If the regulator does not know what is feasible, then the results are likely to be bad in a variety of ways. Either the demands on the firm will be infeasible, or the firm will be cut too much slack and prices will be allowed to go too high, or bad incentives will be created one way or another. We are familiar with all this kind of stuff.

As regulation moves, we hope, yet slowly and gradually away from kind of traditional rate regulation or more clearly moves into new areas such as interconnection, the prospect of regulators having a hard time knowing enough to do the regulation they need to do seems to be more and

more of an issue. How do regulators find out what is feasible? How can regulators find out what is feasible?

It seems to me like there are three generic methods. Maybe there are more. I do not know, but here are three. One is what could politely be described as making an independent assessment or rudely described as trying to run a shadow business, so trying to know the technology, trying to know the structure of demand, trying to do what you would do if you were a conscientious member of the board of directors.

That is pretty hard to do well, and it is pretty hard especially to do well if you are dealing with thinking about imposing an interconnection duty, let's say, that has never been imposed before in that form.

The second thing that a regulator can do, which is the traditional thing that regulators do, is to use information from the firm's past to get an estimate of what the firm can do in the future. That is the traditional approach. In some sense it works, but in some sense it works rather badly.

We are very familiar with some of the bad incentive effects that are created and notice that this, too, does not do you really a bit of good when you are trying to figure out whether sub-loop unbundling in three days at a reasonable price is feasible or not.

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The third thing you can do is to use information from other firms. Notice that this is fundamentally how competitive markets do it. That is to say the standards to which a competitive firm are held are the standards given by the performance of the most successful other firms in the market, and that should clue us in to the idea that this probably has some pretty good features.

Well, it does have some pretty good features. It also has some defects and it has some problems, but those defects and problems surely are not perfectly correlated with the defects and problems of the other methods that regulators can use to figure out what is feasible.

What I mean by that is even though benchmarking relative performance evaluation has its problems, it is surely true that the arsenal or tool kit of information tools that regulators have with it is a heck of a lot better than the arsenal or tool kit that they have without it.

Now notice, and actually Michael made this point a little earlier. Even private firm managers who surely have a much better chance with knowing the technology, knowing the market, independent assessment approach, and who have a much better chance with using good information from the firm's past than do regulators, the FCC, even private managers often use what is called benchmarking.

It is the hot thing of the late 1990s in business

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management is to go off and find out what your competitors are doing by way of responding to customer complaints or whatever it is. This really suggests that relative performance evaluation of various kinds is a very useful tool in finding out what is feasible. As I suggested at the beginning, that is in some sense the key problem of trying to do efficient regulation.

Now, as some of you know and others of you probably are not going to bother to find out, but maybe some will, Bridger Mitchell and I submitted a paper, and there was also an attachment to the paper written by Wilkey Farr. In this paper, we gave lots and lots of examples where the FCC has explicitly used performance comparisons and benchmarking, and we somewhat arbitrarily talked about average practice benchmarking, as in setting a uniform X factor for price caps, best practice benchmarking as in various interconnections --

MR. ROGERSON: Joe, if you had 30 seconds left, what would you say?

MR. FARRELL: Okay. Benchmarking of regulated firms, therefore, really is a used and useful technique for relatively efficient regulation.

So what is the effect of mergers on all of this? First of all, a number of people have made the point, so I will forestall them before they make it again. As usual,

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not much effect if there are plenty of firms left to benchmark against. For some purposes, that probably will be true. I do not think it is really likely to be true for all purposes, especially if economies of scale are significant in this new national market. The comparisons with small ILECs and with CLECs may not do you a lot of good.

There is a loss of pure diversity and a loss of information even if behavior does not change. This point raises some real subtleties, and I think it may be a mistake to spend too long on the subtleties because the real point is --

MR. ROGERSON: It would be at this point, yes.

MR. FARRELL: -- incentives do change. Just as with product market competition, there are a lot of decisions that a firm can make that have opposite side effects on other firms and on consumers. If this firm merges with one of those other firms, then those cross effects on the other firm are going to be internalized, and consumers will lose.

MR. ROGERSON: Okay. Joe has said multiple ILECs mean you can have competition within regulation, and that is useful to the regulator.

Robert Crandall will now tell us why that is not so.

MR. CRANDALL: I am not going to tell you

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necessarily that benchmarks are not useful to the regulator, but I am also not going to read a prepared statement because Roger has scared me into thinking that that looks like something the lawyers went over. Given that I have already compared the people that have hired Rob and me to Eastern Airlines and Bethlehem Steel, I guess there is not much risk.

First of all, it seems to me that you have to keep in mind that what we are involved with here is a transition away from regulation to a situation which market forces and competition between CLECs and ILECs is supposed to dominate the landscape, not regulation from Washington. Even after your victory in the Supreme Court, I mean you only provide guidelines to the states, and even that should wither away over time.

One should not think that benchmarking off a set of firms who grew up in a regulated environment provides you necessarily with efficient benchmarking. Otherwise the GOS plan might have argued you should not privatize Russian steel companies or, you know, at the CAB they might have held on not allowing Slow Hawk and Agony to merge into U.S. Air and drive an airline which today is offering service at one-half the price of the domestic passenger fare investigation standard, which is based on benchmarks.

Secondly, there is nothing in the record here, and

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I have seen nothing from Joe or Bridger, about how much benefit these benchmarks provide. We have some estimates of what the potential benefits from the mergers are. If we stop the mergers in order to maintain a couple of inefficient benchmarks, how much benefit will that provide, and will it offset the benefits from the mergers?

Third, the mergers themselves, if they work, will generate more CLEC activity out of region and provide more CLEC/ILEC sort of benchmarks. Over time, presumably there is going to be more efficient benchmarks as CLECs and ILECs negotiate with each other over the terms of interconnection. It might be terms of interconnections and networks that do not now exist at the ILECs. It might be packets which networks of the sort that AT&T-TCI claim they are going to build now that they have apparently abandoned Project Angel.

Finally, as we move towards a more competitive environment, the whole 271 process has to come to an end at some time soon. Paul Macaboyd claimed it would take ten years for RBOCs to get 271 permission, but it looks as if this process is beginning to move, particularly in New York state, and should spread fairly rapidly after that, at which point the benchmarks necessary for implementing 271 and OSS seem to me to go away.

In addition, looking just parochially at the GTE-Bell Atlantic merger, it is hard to consider GTE as an

appropriate benchmark for Bell Atlantic or some of the other RBOCs. They are not involved in the 271 process. Their entire structure, the dispersed operating systems around the country, are really very different from the RBOCs, and it is hard to argue you are losing a very important benchmark there.

Finally, Joe's point on benchmarks for the X factor, the productivity factor, which is more in your filing than in your oral comments today, suggested you run the risk of internalizing the efficiency gains, which would then have this ratchet effect on providing disincentives for pursuing productivity enhancing investments at the ILECs.

Two things need to be said about that. First of all, there are lots of benchmarks for that around the world. We should not just be looking at U.S. ILECs. Secondly, the Commission has never used the same approach twice, so it would be very hard for an ILEC to try to predict how the X factor is going to be adjusted in the future, given what they have done in the past.

Third, chances are the entire benchmarking thing for X factors should look at a longer period of time because as has been shown in the case of British Telecom and the case of the railroads, productivity gains initially are very rapid when you begin to unleash the regulatory restraints because of the efficiency gains moving off an inefficient

production technology towards a more efficient one.

If you look at deregulated industries in this country, the railroads probably have the greatest rate of productivity gain, hardly not because of enormous technological change, but because they simply are able to move from inefficient operations. I would not put much stock in the notion that you need to preserve independent large ILECs in order to reset the X factor.

MR. ROGERSON: I would like to commend you on getting done before my 30 second warning, Bob. Thank you.

MR. CRANDALL: I am so scared of your tyrannical approach.

MR. ROGERSON: Dennis Carlton?

MR. CARLTON: Thank you.

The relevant question in considering the effect of these mergers on benchmarking is whether the mergers will so significantly impede the ability of regulators to do their job that it will overwhelm the substantial benefits from these mergers.

The question is not whether there is going to be one or two fewer data points for some hypothetical comparison. There is no empirical evidence to support the claim that these proposed consolidations are going to make regulations significantly more difficult.

There is no evidence, for example, that the

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previous RBOC mergers resulted in significant impediments to regulators' ability to do their job. The critics of these mergers who are relying on benchmarking are ignoring ways in which trends in the industry are themselves right now creating more and more benchmarks.

One of the key concerns of regulators today is how an ILEC is going to interact with a CLEC. The most useful tool in evaluating such potential discrimination is to compare the service that ILECs provide to themselves as compared to CLECs in the territory. That is, the ILECs provide an internal benchmark to measure their own performance, and this key benchmark will certainly remain after these mergers.

Moreover, there are new benchmarks constantly emerging in this industry. Just look at what this transaction is going to do. A benchmark is not valuable if everybody is similarly situated. Benchmarks get more and more valuable as people are pursuing different strategies.

SBC is moving out of region. SBC will be interacting with an ILEC out of region. SBC will now have very different incentives than other people in making sure that connections with its out of region ILEC are proper. That, of course, will mean it is pursuing a different strategy. That is when benchmarks start getting more and more informative.

If you look, for example, about a concern, which are benchmarks concerning how new technologies will be hooked up, well, now you have the possibility that we have vertically integrated firms. You can look at how Sprint as an ILEC treats itself as a CLEC.

What you are having in this new environment are smart CLECs able to monitor ILEC performance. You have CLECs that are ILECs in other regions, and you have vertically integrated firms. All of those are new benchmarks that are becoming available.

In Joe's statement, he mentioned that there would be a reduced incentive to engage in productivity enhancing investments because of what he called the ratchet effect; that is, because regulators are going to respond in the future and may lower your prices. In the future, you will have a lower incentive to respond.

That, of course, ignores an opposite incentive, which is there may very well be economies of scale in investment. If that is the case and efficiencies result, you are going to get more, not less investment.

Finally, let me just point out that if the concerns about benchmarking are accurate, SBC has embarked on a strategy in which you would say it is subjecting itself to this cost of benchmarking that Joe was describing. That does not strike me as a reasonable business strategy to be



engaged in if you really think it is a serious problem.

In sum, there is no evidence suggesting that past reductions in the number of ILEC benchmarks have had a significant adverse effect on the ability of regulators to regulate. Given the industry trends and the new information generated not only by this merger, but also by trends in the telecommunications industry, the concern about reducing the number of data points by one or two seem over exaggerated to me. Consumers should not be denied the tangible benefits of these mergers based on unsupported speculation about theoretical harms.

MR. ROGERSON: Okay. First, Roger, does that really mean you want to speak?

MR. NOLL: Yes, I want to speak.

MR. ROGERSON: Okay. Go ahead.

MR. NOLL: I have distinctly mixed feelings about benchmarking, so I will sort of give a critique of everything I have heard.

The first obvious point to say is, Dennis, the value of benchmarking in the competitive industry is zero for the reason that Bob said. Benchmarking is interesting only if you have regulated monopoly. It is not interesting if you have competition.

If the basic premise of the proposals for the merger is true, then it is pro-competitive because it

introduces substantially more competition in long distance services and advanced telecommunications services. Then there is no value to the benchmarking that will arise from the vertically integrated firms because of the fact that we will want to regulate it.

Bob's basic point that you want to think in the long run about what is going to be regulated and what not and evaluate benchmarking on those terms is exactly right. Now, the place that I think that Bob is wrong is that indeed there is a lot of regulation out there; not only regulation by states, but regulations by the FCC of interconnection, so the idea that there are people out there with serious market power in some aspects of this industry is something that in the short run at least we have to bear in mind.

The logic then of Joe's argument about benchmarking as a useful potential tool is completely valid. The only trouble is regulators in the past, notwithstanding Joe's examples, have not really taken advantage of the opportunities for benchmarking, and that is my main concern with the benchmarking argument.

Notice that the FCC in the late 1980s and early 1990s went through this strategy of trying actually to enforce the concept of uniform accounting principles across ILECs and having them all produce quarterly accounting cost estimates that segregated their costs into that which is in

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the FCC's jurisdiction, that which is in the state's jurisdiction and that which is unregulated.

It is the case the FCC did on occasion use that information to in fact pull out some numbers from the rate bases for interstate rate setting purposes of local exchange carriers of the interconnection part of the basis of this benchmark information, so it was used.

The flip side was the resources of the FCC to actually make use of this information were infinitesimal compared to what they would have had to have been to use it completely. That was the subject of not one, not two, but three GAO reports which said how can you possibly have the FCC make use of this information, go to this enormous expense to collect it, when there is no staff to analyze it.

Now we are talking about the FCC here, which is the singularly most sophisticated regulator. North Dakota's regulators are going to make use of this? Uh-uh. I think that is the problem.

Now, there is one point in which I think Joe's argument is absolutely solid, which is not the accounting cost efficiency policing/non-discrimination policing part, but it is in the technical part. That is to say when Company A says it is technically impossible to do X, but Company B is doing it, then the presence of benchmarking is absolutely essential.

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In terms of interconnection, a lot of the issue is about technology. It is about the feasibility of number portability, the feasibility of certain kinds of unbundling, the feasibility of having access to software inside switches.

These are not issues that require enormous staff time to do accounting. These are issues is it true, or is it not. It seems to me there the advantages of multiple local exchange carrier providers are really great, and I think the argument has the most force there.

MR. ROGERSON: I actually gave a much less eloquent version of the last few minutes of your speech at a breakfast meeting the other day.

Allan Campasero, who is actually here in the audience, stood up from GTE and said Bill, that is really a lovely theory. Why do you not give me 15 examples? Why not give me two or three good examples at least, right? Since this is such an important theory, certainly this has been happening in the last while, and you could give me some.

I want to turn Allan's question over to anyone on this panel who would like to deal with it.

MR. FARRELL: Well, there is a voluminous document full of examples. Let me just mention a couple that I remember. The LRN number portability issue, which Bridger and I discussed in some detail, where a number of large

ILECs claimed that LRN was not reasonably implementable in the foreseeable future. I forget the claims, but Ameritech said oh, no problem. We can just do it.

There was, on the other hand, just to say that this is not about Ameritech being particularly special, in a shared transport proceeding Ameritech claimed that it was impossible to do the bookkeeping and billing. Bell Atlantic, on the other hand, was just doing it.

There are a couple of examples. If you want me to pull out my document and leaf through and read some more, I can do that.

MR. ROGERSON: Well, I do not know. Is that enough to convince you, Dennis, or do we need more? I mean, are those good examples?

MR. CARLTON: You know, I think there are two things you can say. You can look at the details of those examples and ask what would have happened but for, okay. That is an interesting experiment about what has happened in the past.

I think there are two responses, though, you should be keeping in mind, two concerns. The first is things are changing. We are getting more competition. We are getting more CLECs. We are getting more ILECs out of region. That is going to give you more information.

Second, if you self-select just one or two bad

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examples, even if they turned out to be true, and I am not suggesting they necessarily are, but even if they were you have ignored the other side of the coin. What about all the benefits?

What about the increased information you are getting from benchmarking because now you have SBC negotiating with an ILEC out of its territory saying I want you to do this, and I know you can do this because I do it. I do it in my territory, so do not give me any baloney that you cannot do it. I am going to tell the regulator you can do it. That seems like an enormous amount of information.

In fact, the FCC in the Bell Atlantic-Ninex decision has exactly such a statement that they understand the benefit that comes about when one ILEC in one region is a CLEC in another.

Pursuing different strategies is giving you new information and giving you new incentives. That is when you are getting information from benchmarking. If everybody stuck in their own territory doing all the same thing, you are going to get very similar responses. It is when you start mixing them up, have some ILECs competing outside their territory against and being a CLEC outside of their territory competing against ILECs. That is when you start getting lots of information, so that would be my response.

Let me just end by saying if you were asked in an

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anti-trust case to ask if prices are going to go up as a result of a merger, I do not think you would find one customer or two customers who said yes, my price is going up. You would ask on average if price is going to go up. On average, are prices going to go up in a new environment?

I think that is the danger that you fall into if you rely on one or two examples, the danger being that you reach a conclusion about average overcomes, the overall outcome to the consumer, based on one or two anecdotes.

MR. ROGERSON: Michael?

MR. KATZ: Well, Roger, I think you got your wish. I do not think that Dennis cleared that last remark with his lawyers because my understanding has always been that the RBOCs have argued vigorously that they are not particularly good at negotiating interconnection agreements out of region, and that is why you should not consider them potential competitors of each other. That is just a statement about their lawyers, not about Dennis.

I do want to address some of the points that Dennis raised and that Bob Crandall raised. Just a couple things on that. One is this issue of well, are there really going to be a lot more benchmarks? I think Bob hit it on the head with exactly what the problem is going to be.

He said well, GTE is not a very good benchmark. They are too much different. Well, how is some little CLEC

that is going to be a hundredth the size and in a very different market position and certainly not under the strictures of 271 then going to be a good benchmark?

We talked about having a lot of CLECs that will monitor. I think CLECs do monitor today, and they complain vigorously to the states and the FCC. The question is how do you tell which one is right?

I am sure there would be a lot of people in the industry who would be happy if the RBOCs would delegate all the authority to make these decisions to COVAD. However, COVAD said we are an intelligent CLEC. We figured out you are doing something bad. Fix it. If you want to stipulate to that, I think it will be fine. It may also bring the industry to a crashing halt, but that is another issue.

Similar to that is this question of internal benchmarks of the LECs serving themselves. The problem there again is I cannot believe the ILECs would want to be held to the standard that says the same service you provide yourself is what you provide to everybody else. I just do not see how they actually believe them when they would say they cannot make their OSS system, make order entry, work the same today for someone outside of the organization as for inside.

I certainly have not seen any willingness that they would grant the same access to the central offices or

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the same access to the software and the switches. I do not think in fact it is probably reasonable in some of those cases to demand the same access, so I do not see how again you can say that these internal benchmarks are going to be a powerful force because I think there are legitimate differences.

I think some of those differences have been overstated, but I think fundamentally there are legitimate differences and so these are not going to be benchmarks that are going to be these great substitutes for having separate RBOCs and separate ILECs.

MR. ROGERSON: Jeff?

MR. SHEPERD: Very briefly. In the literature back in the 1930s, this was all tried in electric industry indirect competition between public and other enterprises. Here, as there, it is not so much what the regulators know that they can order. It is rather what is being done in a diverse way as the theory of innovation teaches us, a variety of things being tried which then not only teach each other, but bring pressure upon each other to try them also.

That is what this merger is likely to stamp out. Therefore, in general do not forget the basis on which we need to think.

MR. ROGERSON: Rob Gertner?

MR. GERTNER: I think it is useful when focusing

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on benchmarks to actually think fairly specifically. It seems essential to think about how the mergers affect the amount of information that is out there. It varies a lot from all across the different things people talk about using benchmarks for. I mean, you really cannot ignore doing sort of the analysis of thinking what are the sources of variation? Why is there different information out there?

Technical feasibility, for example. You want to think carefully about why does one firm think something is technically feasible and others do not? Is it because they had incentives to invest more in R&D that makes it learn that way, or is it because they have a diversity of interests and, therefore, some firms might therefore notice the feasibility in a different way or push towards the feasibility?

If it is diversity of interest, then mergers which lead to greater diversity, like these mergers do, can actually increase the amount of information.

The other thing that is really relevant for all this is the way in which this all feeds back into the incentives of the firms. Again, I think you need to look very carefully across the specific ways in which benchmarks are being used.

In X factor type analysis, mergers that enhance efficiencies, those effects will swamp the ratchet effect

that exists there. Again, it becomes very important to think carefully through about how the benchmarks actually impact the incentives.

MR. ROGERSON: Joe?

MR. FARRELL: Thank you. I hardly know where to start. Let me just take a couple of these points.

First on the creation of new benchmarks and the use of internal benchmarks. I think Michael is right that in many cases the ILECs will argue, and sometimes rightly, that the strict version of this equal provision standard is not reasonable, and that raises the whole question of whether you can reasonably do it. That is something that again regulators need to have more information to do.

Let me also point out that even if you can and do do it, it is not enough. The equal provision standard solves a static version of a certain leveraging problem. It does not solve the dynamic version of leveraging problems, so suppose that an ILEC is providing input, A, and ILECs and others are providing in a complementary business B, and suppose that somebody other than the ILEC wants to innovate in B and needs cooperation from the ILEC's provision of A, for example, as with long distance and with access service.

Then the ILEC can stymie that competitive innovation without violating the equal provision standard because it does not need to provide this cooperation to

itself because it does not have that innovation. By imposing the equal treatment standard, not only are you providing only low powered incentives at best for the ILEC's provision of this monopoly service, but you are also allowing it to monopolize innovation in the competitive segment.

Secondly, if you say that the ILEC has to equally provide A to itself and to others, you have done absolutely nothing to get efficient provision of A. You may have solved some leverage problem into B, or you may not, but you have done nothing for the provision of the monopoly input, A, and that is exactly, of course, where you may need regulation and where you may need benchmarking to provide good information so you can do not too bad regulation.

Let me also come back to a point Bob made about the so-called unpredictable adjustment of the X factor. I think it is true that the way the Commission has behaved and the way other people have behaved elsewhere and just thinking about the political economy, nobody can really know for sure how the X factor will be adjusted and when. It is absolutely not true that that implies that each ILEC is going to assume that the X factor is completely exogenous to its actions.

Just to give you an example, back in 1997 when there was the access reform proceeding, there were parties

who argued that there should be company by company level re-initialization. In other words, take away any so-called excess profits company by company. That did not happen. I am glad it did not happen, but it obviously was not common knowledge that it would not happen.

Yes, there is uncertainty about how X factors get adjusted, but, no, that does not imply that everybody, therefore, makes decisions as if the X factor is going to be completely exogenous to their technical process.

MR. ROGERSON: Have I reached that point where I should turn the audience loose?

Rich? Rich Gilbert?

MR. GILBERT: I want to say one thing, which is it seems that what you said about the dynamic access story is also a reason in favor of the merger as a better benchmark. Let me explain.

If ILECs are confined to essentially their local focused strategy focused on their own territories paired to a national local strategy where you are anticipating providing integrated services, primarily a bigger package of services and direct competition with the IXEs, you have an incentive to do more things and to offer more services and to, therefore, provide those services nationwide that you might not be providing with a different strategy.

It really also speaks to this point that it is

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different behaviors, it is different business strategies, that can produce different benchmarks.

MR. ROGERSON: Joe, do you want to directly respond to that?

MR. FARRELL: Yes, that is what I want to do. Look, if you really believe that these mergers are both necessary and sufficient conditions for a really vigorous out of region entry, then I think they should go ahead, and the sooner the better.

MR. GILBERT: We do.

MR. FARRELL: But I think there is a lot of skepticism and there is substantial grounds for skepticism about perhaps whether and certainly how much of that there really is. Then you have to start focusing on well, what if not?

MR. CARLTON: Do you agree, Joe, that these mergers will accelerate out of region entry and, therefore, the benefits to consumers from new products, as well as more competition, will come faster?

If it is a benefit and we know the benefits from new products are tremendous, is that not a fact that should weigh in your thinking as you think about stopping the mergers to preserve benchmarks, as well as the fact that in the future there are going to be more competition and more vertical integration?

MR. FARRELL: Yes. I think that is exactly the question that I just answered.

If you believe that these mergers are both a necessary condition and a sufficient condition for these LECs plunging wholeheartedly into out of region facilities based competition, then I think that is great. If you are not convinced of that, then you obviously have to discount your consideration.

MR. CARLTON: But does that mean you would stop a merger in a non-regulated context on the same grounds, hoping that the companies would do whatever it is they are going to do together on their own?

In other words, what you have here when you have a merger is you have a business plan. You have investments in a business plan, statements to their investors, a lot of money spent already on these plans. I do not understand how you can not say that that means they are prepared to go faster than if I say no, you cannot do the merger. You figure out what you want to do. Go back to the drawing board.

MR. LITAN: Dennis, even if what you say is true discounted with some probability, it is still something that you put on the scales, and you compare it to the other potential harms that we are going to talk about, and then you decide, you know, where the overall balance is.

MR. CARLTON: I agree. I am just saying --

MR. LITAN: We are debating how heavy we want to put the scale of the pro-competitive arguments. It is certainly a relevant factor.

MR. CARLTON: Right. That is the point I wanted to make.

MR. CRANDALL: Can I just make one point in response to Joe, and that is I do not know how much we are going to lose in the way of benchmarks even over the traditional issues that Joe raises, and he raises a couple of examples.

He did not mention the British Water and Sewerage Administration example, which I do not think will bear much on our problem here today, but the fact is that a lot of these issues are arbitrated between parties at the state by state level. These mergers may not reduce benchmarks at all in that regard, number one.

Number two, this issue of the fact that we are going to have more efficient, different technology companies entering out of region, for instance, Bell Atlantic and GTE, with an Internet backbone, with a much more complete array of services, something which nobody has responded to in Rob's presentation.

It seems to me you are likely to get some better benchmarks, and you are not going to lose that much in the



way of benchmarks from the traditional negotiations anyway, given the state by state regulation.

MR. ROGERSON: Joe?

MR. FARRELL: Okay. Let me say for the third time if serious, vigorous, effective out of region entry, that would be a great thing. If the mergers are both a necessary condition and a sufficient condition for that, then that may well dominate any other considerations.

Now back to your other point about the state level, the state level analysis. This gets a little bit to the subtleties that we talked about before. Do you really get the same information? I think again the main point there is you get different incentives, so the state level analysis says, of course, if you have mergers of holding companies that does not change the operating company level behavior, then you get no direct impact on the information flow, but because there is a change in incentives you will get a change in the information flow and a change in the efficiency of behavior as a result of that. I think that is really the robust point to focus on.

MR. ROGERSON: Okay. We have time for one or two questions from the audience. This time I will not insist that they be thoughtful or witty.

Allan Campasero? Okay, Allan.

MR. CAMPASERO: I had to take this chance. This

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is a very interesting general discussion of benchmarks. Of course, for us it is a specific deal that is at stake here.

I cannot think of and I wonder if anybody can think of an instance where GTE has been used as a benchmark for the RBOCs?

MR. ROGERSON: These are the same kind of questions he was asking me at breakfast the other day, guys. Who would like to take a shot at that? Anyone?

MR. NOLL: There actually is one example. The cost study that was done in California about ten years by Bridger Mitchell --

MR. ROGERSON: Roger, we cannot hear you.

MR. NOLL: Okay. The cost study that was done about ten years ago for the California Public Utilities Commission on the extent of what actually is local access cost and at what size of an exchange do you exhaust the economies of scale was actually based upon both GTE and Pac Bell cost studies.

In fact, most of the information about the smaller cities came from GTE, and it was used by the California Public Utilities Commission for a generic regulatory proceeding that affected both of them.

To think of it the other way, of course, is that GTE, and I do not know where the biggest GTE investment in the whole world is, but certainly Los Angeles has got to be

right up there, so GTE in California is more like an RBOC than it is like a little, tiny guy, which it is in lots of other places.

MR. ROGERSON: Mario Schwartz?

MR. SCHWARTZ: Yes. Just a quick clarifying remark. Even if GTE was not used as a benchmark against the RBOCs, as long as the RBOCs were used as a benchmark against GTE you would still expect the merger to make a difference in the parties' incentives and, therefore, get less benchmarking.

MR. ROGERSON: There is a question over there. Would you mind telling us your name and your affiliation before you ask your question?

MR. CLARK: I am Rich Clark with AT&T, and I guess I would like to address about three or four years ago there was a proposal by Pacific Bell that it was going to replace its copper pair network with a hybrid fiber co-ax network. These plans were cancelled after SBC took over Pacific Bell, and I guess we are now waiting to see if AT&T and TCI can make that work.

I would suggest that there are situations where, you know, these mergers have already had the effect of eliminating diversity or possibility for benchmarks of different technologies.

MR. ROGERSON: Rich Gilbert, do you want to

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respond?

MR. GILBERT: I would just like to respond that the merger with Telesys refocused their efforts on new services, and they have had a really accelerated roll out of high band with DSL services.

MR. ROGERSON: Bob Crandall?

MR. CRANDALL: It seems to me that the fact that SBC re-evaluated their architecture and decided not to go ahead with that is not any more damaging to the notion that now they are going to try another strategy to enter out of region than perhaps denying your merger with TCI because you never really got fixed wireless going very well.

MR. ROGERSON: Okay. We have one more question from the back, and then we will break. We will take our break.

MS. BLOOMENFELD: Sue Bloomenfeld with Wilkey Farr. I just wanted to fill out I think Rich's question, which is the point was that in seeking merger approval, SBC and Pac Tel promised the Commission that that video experiment and build out would continue post merger, and then the plans were changed. I think maybe that may be relevant here.

MR. ROGERSON: Okay. Who would like to give me an economic analysis of that question?

MR. GILBERT: I would still like to respond by

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saying from a consumer's point of view, the concern is what is the availability of high band services. On that measure, the merger has done very well. There is no question that now SBC with Telesys has the highest DSL roll out I think of any ILEC.

MR. ROGERSON: Great. Okay. We will take a 15 minute break, and we will resume at 11:00 a.m. with Session Three.

(Whereupon, a short recess was taken.)

MR. ROGERSON: No FCC round table involving economic analysis would be complete without us parading out our own Commissioner, who is in fact an economist, Commissioner Furchgoti-Roth. He has kindly agreed to make a few remarks to us all prior to starting our third session.

Commissioner Furchgoti-Roth, please go ahead.

MR. FURCHTGOTT-ROTH: Thank you, Bill.

I first want to thank all the panelists for taking time out of their busy schedules to come here to the Commission. We are very honored to have you here today. It is a rare privilege to have such eminent economists all come together at one time, and I think it is a great tribute to you, Bill, for having organized this and having very thoughtfully brought together all these wonderful people. I am sure we are all learning a great deal about the proposed mergers.

As in a lot of topics here at the Commission, I come at this with a slightly different perspective than some other folks at the Commission. I have no idea whether these proposed mergers or any of the dozens of other proposed mergers that might be here at the Commission present any anti-competitive problems, and I am sure that the panelists here have some very strong view of it and many of you in the audience as well.

I am very interested in finding out what the proper role of the FCC as an institution is in reviewing these mergers or really any other mergers. I very much look forward to reading the transcripts or seeing the videotapes of these proceedings. They may not be quite as interesting as Monica Lewinsky, but I think there may be something here to be learned.

As many of you know, the FCC's authority to review mergers comes in two areas. One is directly out of the Clayton Act, and I am not quite sure if the Commission has ever used that. Secondly is through the licensing process through Sections 208 through 210 or 214, and that is how the Commission has chosen to review mergers and is reviewing these.

The difficulty we have, as far as I can tell, and I have requested and have yet to find them, is the specific rules by which the Commission reviews these mergers. We

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certainly have some case history that we do not have specific written rules.

I would be very interested if any of you have seen any such thing or, to the extent you have not, if you could give us any guidance as to what such rules might look like under 208 through 210 and 214 and in particular how those would differ from the DOJ/FTC merger guidelines.

All of you on this panel I suspect have had some interest in these mergers and have made presentations either to DOJ or possibly to state regulators, and I am curious if the issues that you think the FCC should consider are in any way materially different from the issues that the Department of Justice should consider in its merger reviews and if the standards that the FCC should apply are in any way different from those that the Department of Justice would apply. If they are different, should they be written down, codified, memorialized in some way that would set some clear guidance to the public about how this Commission will review mergers.

I think we can get very quickly to the issue of whether there is anything in the presentations that you have made here today that are different from the information that you have already presented to the Department of Justice and, if so, what triggered that. Why is that different? How have you come to that conclusion?

I do not know what the right answers are to any of

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